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Downunder Daily

Back at the Ranch…

That US housing is in a bad way is not news, but it's worth noting just how bad, because the knock-on effects will be important.

First, it seems that house price declines are accelerating. No one price measure is perfect, but two of the better monthly measures – the Case-Shiller index and the new monthly index from the OFHEO – are declining at the fastest pace in their history (Exhibit 1). (This OFHEO index includes only purchase-related transactions, not refinancing.)

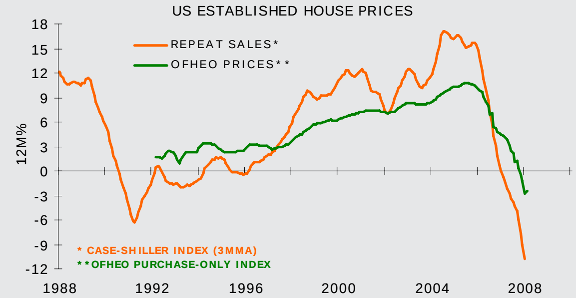
America may now face its first nationwide decline in nominal house prices since the Great Depression, but house prices have fallen in real terms several times since then. The current decline – so far – is not unusual compared with the real price falls seen in the early 1980s and early 1990s. What is unusual is the starting point (Exhibit 2).

Second, supply shows no sign of abating. The number of single-family homes for sale (relative to the stock of existing homes) is now at the highs seen in the mid-1980s. The number of homes that are both for sale and vacant – and thus presumably reflect anxious sellers – is at an all-time high (Exhibit 3).

The supply of homes is being increased by foreclosures. The rise in foreclosures over the past two years has been larger than the decline in new home starts (Exhibit 4). That is, the fall in one source of supply (construction) is being more than offset by increased supply due to credit stress.

Exhibit 1

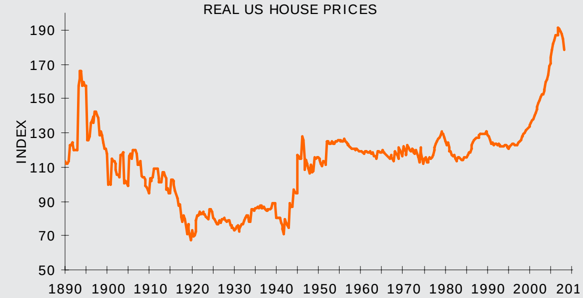
Accelerating Price Decline



Source: OFHEO, S&P/Case-Shiller; Morgan Stanley Research

Exhibit 2

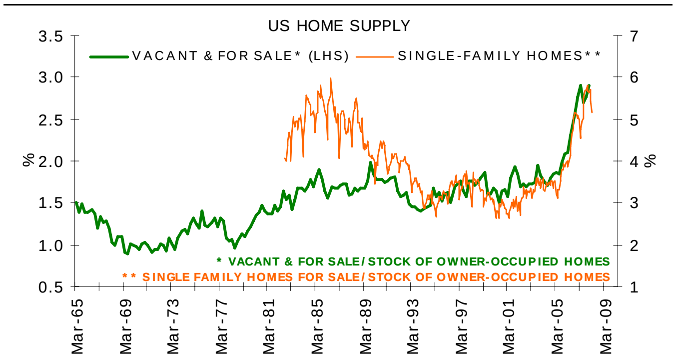
Not the First Fall; Not the Biggest (So Far)



Source: Robert Shiller, OFHEO, BLS; Morgan Stanley Research

There are three notable consequences of the ongoing distress in housing:

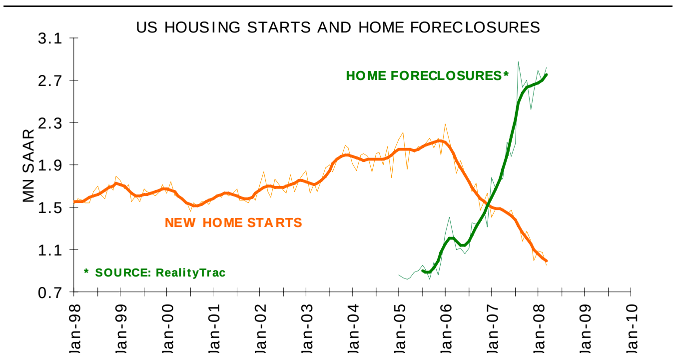
Exhibit 3
More Supply



Source: Census Bureau, NAR; Morgan Stanley Research

First, residential construction will continue to be a drag on GDP. Residential construction has already knocked more than 2% off GDP growth, but now seems set to fall to the lows seen in the early 1980s/1990s, which points to another 1% cut in GDP (Exhibit 5). Our US Economics team expects housing construction to keep falling until the first half 2009.

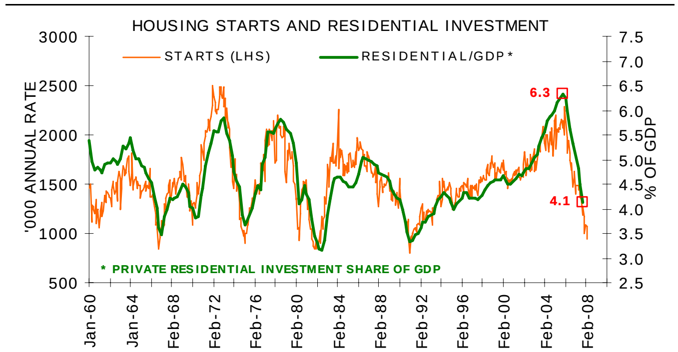
Exhibit 4
More Foreclosures



Source: NAR, Reality Trac Morgan Stanley Research

Second, the decline in house prices and – as importantly – housing turnover will likely lead to a further reduction in home equity extraction. Extraction and turnover have followed each other in this cycle (Exhibit 6). Home equity withdrawal has been an important financing source for a household sector that remains cash-flow negative. The reduced ability to fund that deficit is one reason (of several) to expect weaker consumer spending going forward.

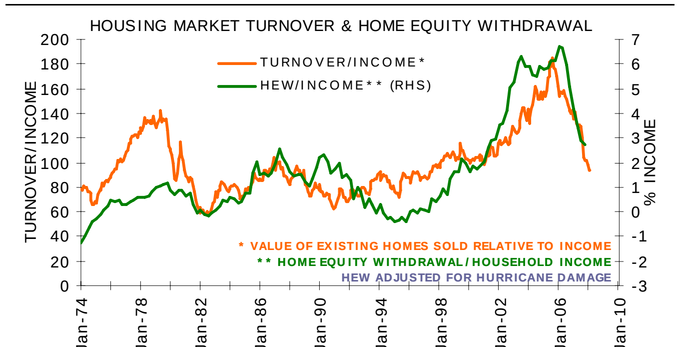
Exhibit 5
More GDP Drag



Source: BEA, Commerce Department; Morgan Stanley Research

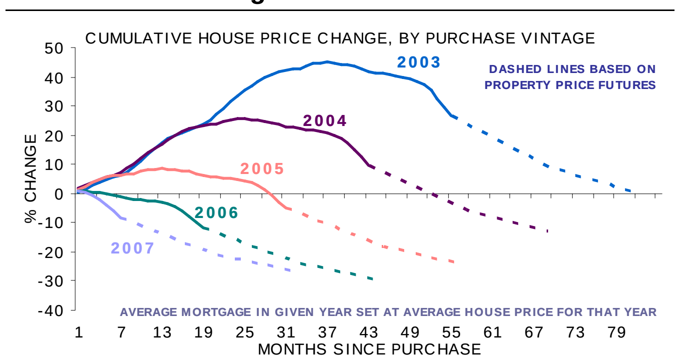
Finally, the ongoing price declines are likely to worsen credit performance. It's clear that delinquency and default rates in this cycle are being influenced by prices. If the futures markets are right, then a large number of additional homeowners will soon face the prospect of negative equity (Exhibit 7).

Exhibit 6
More Financing Drag



Source: Federal Reserve, BEA, NAR; Morgan Stanley Research

Exhibit 7
More Bad Debt Drag



Source: S&P/Case-Shiller, Radar Logic; Morgan Stanley Research

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